

Letter of Findings: 02-20130209
Corporate Income Tax
For the Tax Years 2008-2010

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ISSUES

I. Corporate Income Tax—Determination of "State Tax Addbacks."

Authority: [IC 6-3-1-3.5](#); [IC 6-8.1-5-1](#); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Consolidation Coal Co. v. Indiana Dep't. of State Revenue, 583 N.E.2d 1199 (Ind. 1991); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Aztar Indiana Gaming Corp. v. Indiana Dep't. of State Revenue, 806 N.E.2d 381 (Ind. Tax Ct. 2004); First Chicago NBD Corp. v. Indiana Dep't of State Revenue, 708 N.E.2d 631 (Ind. Tax Ct. 1999); Flint v. Stone Tracy Co., 220 U.S. 107 (1911); Mich. Comp. Laws Ann. 208.1111; Mich. Comp. Laws Ann. 208.1113; Mich. Comp. Laws Ann. 208.1201; Mich. Comp. Laws Ann. 208.1203; Mich. Comp. Laws Ann. 208.1301; Tex. Tax Code Ann. 171.002; Tex. Tax Code Ann. 171.101; Tex. Tax Code Ann. 171.1011; Tex. Tax Code Ann. 171.1012; Tex. Tax Code Ann. 171.1013.

Taxpayer protests the imposition of adjusted gross income tax based upon the Department "adding back" the Texas Franchise Tax and the "gross receipts portion" of the Michigan Business Tax.

II. Corporate Income Tax—Apportionment: Sales Factor Numerator.

Authority: [IC 6-3-2-1](#); [IC 6-3-2-2](#); [IC 6-8.1-5-1](#).

Taxpayer protests the imposition of adjusted gross income tax based on adjustments to its sales factor numerator that relate to "Illinois sales" that were mistakenly included in the sales factor numerator.

III. Tax Administration—Underpayment Penalties.

Authority: [IC 6-3-4-4.1](#).

Taxpayer protests the imposition of the underpayment of estimated tax penalties.

STATEMENT OF FACTS

Taxpayer, a corporation, is in the business of manufacturing, distributing, and selling various paints and coatings. The Department of Revenue ("Department") conducted an audit review of Taxpayer's business records and tax returns. The audit resulted in the assessment of additional income tax and interest for the 2008, 2009, and 2010 tax years. As a result of the additional income tax due from the audit assessments, Taxpayer was also assessed underpayment of estimated tax penalties for the 2008 and 2010 tax years. Taxpayer protested. An administrative hearing was conducted, and this Letter of Findings results. Additional facts will be provided as necessary.

I. Corporate Income Tax—Determination of "State Tax Addbacks."

DISCUSSION

The Department assessed Taxpayer additional adjusted gross income tax on the ground that Taxpayer failed to add back the Texas Franchise Tax and the "modified gross receipts tax" portion of the Michigan Business Tax. The Department's audit report states that these taxes are state taxes that are based upon income and that Indiana law requires that all taxes based on or measured by income, which are levied by any subdivision of any state, must be added back to Federal taxable income.

Taxpayer maintains that the Texas Franchise Tax and the "modified gross receipts tax" portion of the Michigan Business Tax are not taxes based upon income.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in [IC 6-8.1-5-1\(c\)](#), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012).

In calculating "adjusted gross income," Indiana law requires the add back of certain state levied income taxes. [IC 6-3-1-3.5\(b\)](#) provides, in relevant part:

When used in this article, the term "adjusted gross income" shall mean the following . . . [i]n the case of corporations, the same as "taxable income" (as defined in Section 63 of the Internal Revenue Code) adjusted as follows:

...

(3) Add an amount equal to any deduction or deductions allowed or allowable pursuant to Section 63 of the Internal Revenue Code for taxes based on or measured by income and levied at the state level by any state of the United States.

...

Therefore, the issue is whether the Texas Franchise Tax and the "modified gross receipts tax" portion of the Michigan Business Tax are taxes "based on or measured by income"

Texas Franchise Tax

While the Texas tax has been designated as a "margin tax" or "franchise tax," merely labeling the tax as such does not change the nature of the tax. As explained in *Flint v. Stone Tracy Co.*, 220 U.S. 107, 145 (1911), "[T]he mere declaration contained in a statute that it shall be regarded as a tax of a particular character does not make it such if it is apparent that it cannot be so designated consistently with the meaning and effect of the act." In *Consolidation Coal Co. v. Indiana Dep't. of State Revenue*, 583 N.E.2d 1199 (Ind. 1991), although it had been characterized as a gross receipts tax, the Indiana Supreme Court found that the "West Virginia's Business and Occupation Tax" was in fact a tax that was "based on or measured by income" and, therefore, was subject to the add back provision in [IC 6-3-1-3.5\(b\)\(3\)](#). In doing so, the court reasoned that "the whole phrase, 'based on or measured by income' seems likely to be used in the same, simple sense which defined the inquiry in [*Miles v. Department of Treasury*, 199 N.E. 372 (Ind. 1935)]. Is the tax which payor wishes to add back measured by income? Or [is it] measured by value of property held?" *Id.* at 1202.

Again, in *Aztar Indiana Gaming Corp. v. Indiana Dep't of State Revenue*, 806 N.E.2d 381 (Ind. Tax Ct. 2004), although it had been characterized as an excise tax measured by the petitioner's adjusted gross receipts received from gaming activities, the Indiana Tax Court found that the Riverboat Wagering Tax was subject to Indiana's add back provision because the tax was "based on or measured by income." *Id.* at 386. The Indiana Tax Court, in finding that the Riverboat Wagering Tax ("RWT") was a tax "based on or measured by income," reasoned:

In this case, it is clear that the RWT is an excise tax: it is not payable unless the privilege of conducting riverboat gambling is exercised and the exercising of those privileges is the occasion for the imposition of the tax. See *Fort Wayne Nat'l Corp.*, 649 N.E.2d at 111 (citing *Lutz*, 193 N.E. at 844). Nevertheless, it is an excise tax that is measured by income. Indeed, Aztar's RWT liability calculation is measured by the adjusted gross receipts it receives from its gaming operations: all cash and property received by Aztar from its gaming operations (minus certain adjustments) certainly constitute income to Aztar. See A.I.C. 4-33-2-2. *Id.*

In *First Chicago NBD Corp. v. Indiana Dep't of State Revenue*, 708 N.E.2d 631 (Ind. Tax Ct. 1999), the Indiana Tax Court, in finding that the Michigan Single Business Tax ("MSBT") was not a tax "based on or measured by income," reasoned:

In the MSBT formula, corporate outlays such as wages are added to income to calculate the tax base. This formula is therefore not designed to measure income but rather the value added through the production process. In contrast, a tax based on or measured by income would be calculated by subtracting such outlays in order to arrive at the income or profit made after the product is sold, and a tax measured by gross income or gross receipts would not add such outlays—it would merely look to what the taxpayer received during that tax period. (Emphasis in original). *Id.* at 634.

The starting point for determining a corporation's "taxable margin" for the Texas Franchise Tax is the corporation's "total revenue." Tex. Tax Code Ann. 171.101(a). The corporation's "total revenue" is "computed by adding: (i) the amount reportable as income on line 1c, Internal Revenue Service Form 1120 [to] (ii) the amounts reportable as income on lines 4 through 10, Internal Revenue Service Form 1120" Tex. Tax Code Ann. 171.1011(c)(1)(A). Thus, Texas law provides that a taxable entity's revenue – for Franchise Tax purposes – is determined by using the federal income numbers from that entity's federal income tax return. Tex. Tax Code Ann. 171.1011(c)(1)-(2). Once a taxable entity determines its total revenue based on the numbers derived from the federal income tax return, the entity then subtracts certain expenses that it reported on that federal return. Tex. Tax Code Ann. §171.101(a), .101(c). Next, the entity subtracts certain other statutorily defined deductions to arrive at the entity's "taxable margin." Tex. Tax Code Ann. §171.1012-.1013. After the entity has computed its "taxable margin," it multiplies this computed amount by the applicable tax rate. Tex. Tax Code Ann. 171.002(a)-(b). The tax rate is .5 percent for retailers and wholesalers and one percent for all other industries. *Id.* This calculation results in the amount of margin tax the entity owes the state of Texas.

The Texas tax computation, by statute, starts with and is based on totaling the entity's income as reported on the federal income tax return. After certain expenses and deductions are subtracted adjusting that amount, a tax of either .5 or one percent is calculated and imposed. Therefore, it is apparent from the face of the law that the Texas tax is a tax that is "based on or measured by income . . ." and is required to be added back pursuant to [IC 6-3-1-3.5](#). As explained in *First Chicago NBD* and *Aztar*, a tax calculated by totaling a taxpayer's income, cash, or property received, and subtracting outlays, expenses, or other adjustments in order to arrive at the income or profit made is a tax that is based on income or measured by income.

Accordingly, Taxpayer's protest of the imposition of adjusted gross income tax based upon the Department "adding back" the Texas Franchise Tax is denied.

Michigan Business Tax: "Modified Gross Receipts Tax"

The Michigan Business Tax, in effect for the tax years in question, has two components relevant to Taxpayer's filings: a "Business Income Tax" found at Mich. Comp. Laws Ann. 208.1201 and a "Modified Gross

Receipts Tax" found at Mich. Comp. Laws Ann. 208.1203. Taxpayer asserts that only the amount that it paid for the "Business Income Tax" portion of the Michigan Business Tax is "based on or measured by income" and is required to be added back pursuant to [IC 6-3-1-3.5](#). Taxpayer maintains that the amount it paid for the "Modified Gross Receipts Tax" portion of the Michigan Business Tax is not a tax measured by income and, therefore, is not required to be added back.

The starting point for determining a taxpayer's "modified gross receipts" for the "Modified Gross Receipts Tax" portion of the Michigan Business tax is the taxpayer's "gross receipts" Mich. Comp. Laws Ann. 208.1203(1), (3). The taxpayer's "gross receipts" are any "amount[s] received by the taxpayer as determined by using the taxpayer's method of accounting used for federal income tax purposes" except for the specific enumerated receipts less "any amount[s] deducted as bad debt for federal tax purposes . . . phased in over a 5-year period." Mich. Comp. Laws Ann. 208.1111(1). Once a taxpayer determines its gross receipts for a tax year, the taxpayer then subtracts certain enumerated business expenses—i.e., amounts incurred during the year for federally depreciable assets, inventory, materials, and supplies. Mich. Comp. Laws Ann. §208.1203(3), .1113(6)(b). Next, the "modified gross receipts" are either allocated directly to Michigan or apportioned to Michigan, based upon the place where the taxpayer's business activities occurred, to arrive at the "apportioned modified gross receipts." Mich. Comp. Laws Ann. §208.1203(1), .1301(2). After the taxpayer has determined the apportioned modified gross receipts, it multiplies this amount by the .8 percent tax rate. Mich. Comp. Laws Ann. 208.1203(1). This calculation results in the amount of "modified gross receipts tax" the taxpayer owes the state of Michigan.

The "Modified Gross Receipts Tax" portion of the Michigan Business Tax computation, by statute, starts with and is based on totaling the entity's gross receipts. After certain expenses and deductions are subtracted making adjustments to that amount and an apportioned method is applied, a tax of .8 is calculated and imposed. Therefore, it is apparent from the face of the law that the "Modified Gross Receipts Tax" is a tax that is "based on or measured by income . . ." and is required to be added back pursuant to [IC 6-3-1-3.5](#). As explained in First Chicago NBD and Aztar, a tax calculated by totaling a taxpayer's income, cash, or property received and subtracting outlays, expenses, or other adjustments in order to arrive at the income or profit made is a tax that is based on income or measured by income.

Accordingly, Taxpayer's protest to the imposition of adjusted gross income tax based upon the Department "adding back" the "modified gross receipts tax" portion of the Michigan Business Tax is respectfully denied.

FINDING

Taxpayer's protest of the imposition of adjusted gross income tax based upon the Department "adding back" the Texas Franchise Tax and the "gross receipts portion" of the Michigan Business Tax is respectfully denied.

II. Corporate Income Tax—Apportionment: Sales Factor Numerator.

DISCUSSION

The Department determined that Taxpayer had failed to include a number of its Indiana sales in its sales factor numerator in each year and made adjustments to account for these additional Indiana sales.

During the years at issue, Indiana imposed a tax on each corporation's adjusted gross income attributable to "sources within Indiana." [IC 6-3-2-1\(b\)](#). Where a corporation – such as Taxpayer – receives income from both Indiana and out-of-state sources, the amount of tax is determined by the apportionment formula set out in [IC 6-3-2-2\(b\)](#). That formula operates by multiplying the taxpayer's total business income by a fraction composed of a property factor, a payroll factor, and a sales factor. [IC 6-3-2-2\(b\)](#).

The "sales factor" consists of a fraction, "the numerator of which is the total sales of the taxpayer in [Indiana] during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year." [IC 6-3-2-2\(e\)](#). "Regardless of the f.o.b. point or other conditions of the sale, sales of tangible personal property are in this state if the property is delivered or shipped to a purchaser that is within Indiana." [IC 6-3-2-2\(e\)\(1\)](#).

Taxpayer asserts that the Department overstated the adjustments made to its sales factor numerator for the additional Indiana sales. Taxpayer maintains that the Department mistakenly included Taxpayer's sales to "Customer W" in the adjustments to the sales factor numerators in each year. Taxpayer states that its sales to "Customer W" were not Indiana sales, but were "Illinois sales" that should not be included in the Indiana sales factor numerator.

During the hearing, Taxpayer presented documentation, including invoices and bills of lading, to establish that its sales to "Customer W" occurred in Illinois and were Illinois sales. These records demonstrate that "Customer W" purchased the goods in Illinois and took physical and legal possession of the goods in Illinois. Therefore, Taxpayer has met its burden of proof, pursuant to [IC 6-8.1-5-1\(c\)](#), establishing that – for the audit years 2008, 2009, 2010 – these specific sales to "Customer W" were Illinois sales and should not be included in the sales factor numerator.

FINDING

Taxpayer's protest of the imposition of adjusted gross income tax based upon adjustments to the sales factor numerator relating to Taxpayer's sales to "Customer W" is sustained.

III. Tax Administration—Underpayment Penalties.

DISCUSSION

The Department issued proposed assessments for the underpayment of estimated penalties for the 2008 and 2010 tax years under [IC 6-3-4-4.1\(d\)](#). Taxpayer protested the imposition of the underpayment penalties that were assessed as a result of the additional income tax from the audit adjustments.

[IC 6-3-4-4.1\(d\)](#) provides:

The penalty prescribed by [IC 6-8.1-10-2.1\(b\)](#) shall be assessed by the department on corporations failing to make payments as required in subsection (c) or (f). However, no penalty shall be assessed as to any estimated payments of adjusted gross income tax which equal or exceed:

- (1) the annualized income installment calculated under subsection (c); or
- (2) twenty-five percent (25[percent]) of the final tax liability for the taxpayer's previous taxable year.

In addition, the penalty as to any underpayment of tax on an estimated return shall only be assessed on the difference between the actual amount paid by the corporation on such estimated return and twenty-five percent (25[percent]) of the corporation's final adjusted gross income tax liability for such taxable year.

Taxpayer has met its burden of demonstrating that the imposition of the underpayment penalties is not appropriate.

FINDING

Taxpayer's protest of the imposition of the underpayment penalties as a result of the imposition of additional income tax from the audit adjustments is sustained.

SUMMARY

Taxpayer's protest of the imposition of adjusted gross income tax based upon the Department "adding back" the Texas Franchise Tax and the "gross receipts portion" of the Michigan Business Tax is respectfully denied, as discussed in Issue I. Taxpayer's protest of the imposition of adjusted gross income tax based upon adjustments to the sales factor numerator relating to Taxpayer's sales to "Customer W" is sustained, as discussed in Issue II. Taxpayer's protest of the imposition of the underpayment penalties as a result of the additional income tax from the audit adjustments is sustained, as discussed in Issue III.

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